

**MEMO# 15410**

December 2, 2002

# **SEC PROPOSAL TO EXEMPT CERTAIN RESEARCH & DEVELOPMENT COMPANIES FROM DEFINITION OF INVESTMENT COMPANY**

[15410] December 2, 2002 TO: SEC RULES COMMITTEE No. 99-02 RE: SEC PROPOSAL TO EXEMPT CERTAIN RESEARCH & DEVELOPMENT COMPANIES FROM DEFINITION OF INVESTMENT COMPANY The Securities and Exchange Commission has proposed Rule 3a-8 under the Investment Company Act of 1940, which would provide a nonexclusive safe harbor from the definition of investment company for certain bona fide research and development companies.<sup>1</sup> The proposed rule is summarized below. Comments on the proposed rule must be filed by January 15, 2003. Accordingly, persons with comments on the proposal should provide them to the undersigned no later than Friday, December 20. Comments can be submitted by phone (202-326-5819) or by email (adubey@ici.org). The Commission notes that certain activities of research and development companies may cause them to fall within the definition of investment company and to fail to qualify for an exclusion from the definition. In particular, the Commission states that research and development companies often raise large amounts of capital, invest the proceeds and use the principal and return on these investments to fund research and development activities during their lengthy product development phase. In addition, the Commission states that a research and development company may purchase a non-controlling equity stake in another research and development company as part of a strategic alliance with the other company to conduct research and develop products jointly. Proposed Rule 3a-8 A company would be eligible to rely on the rule's nonexclusive safe harbor from the definition of investment company if it satisfies the conditions set forth in the rule, as described below. The safe harbor would be available to any company that conducts business directly, through majority-owned subsidiaries, or through one or more companies, which it "controls primarily." The proposed rule defines "controlled primarily" as having control over a company within the meaning of Section 2(a)(9) of the Investment Company Act and that the degree of control is greater than that of any other person. 1 Proposed Rule: Certain Research and Development Companies, SEC Release No. IC-25835 (November 26, 2002). The proposing release is available on the Commission's website at [www.sec.gov/rules/proposed/ic-25835.htm](http://www.sec.gov/rules/proposed/ic-25835.htm). 2 1. Substantial Research and Development Expenses The research and development expenses for the company's last four fiscal quarters combined would be required to be a substantial percentage of its total expenses for that period.<sup>2</sup> The proposed rule does not define "substantial" in order to allow companies to take in to account fluctuations in the composition of their expenses over time. The Commission notes that, if a company's research and development expenses are the

majority of its expenses, but for nonrecurring items or unusual fluctuations in recurring items, the research and development expenses would be “substantial” for purposes of the rule.

2. Revenues from Investments Compared to Research and Development Expenses Revenues from “investments in securities” would be required not to exceed twice the amount of the company’s research and development expenses. The proposed rule defines “investments in securities” to include all securities owned by the company other than securities issued by majority-owned subsidiaries and companies controlled by the company that conduct similar types of businesses, through which the company is engaged primarily in a business other than that of investing, reinvesting, owning, holding, or trading in securities. Investment revenues, for purposes of the proposed rule, would include all investment returns, including amounts earned from dividends, interest on securities, and profits on securities (net of losses).

3. Insignificant Investment Related Expenses The company would be required to devote no more than five percent of its total expenses for its last four fiscal quarters combined to investment advisory and management activities, investment research and selection, and supervisory and custodial fees.

4. Investments to Conserve Capital and Liquidity The company’s investments in securities would be required to consist of “capital preservation investments,” subject to two exceptions for “other investments.” The proposed rule defines “capital preservation investments” as investments made to conserve capital and liquidity until the funds are used in a company’s primary business or businesses. The proposed rule would permit a company to acquire “other investments” (i.e., investments that are not capital preservation investments), provided that immediately after the acquisition (a) no more than 10% of its total assets consist of other investments or (b) no more than 20% of its total assets consist of other investments so long as at least 75% of those investments were made pursuant to “collaborative research and development arrangements.”<sup>3</sup> The proposed rule defines “collaborative research and development arrangements” to include business relationships that (a) are designed to achieve narrowly focused goals that are directly related to, and an integral part of, the company’s research and development activities; (b) call 2 The proposed rule provides that a company’s assets, expenses and revenues should be determined on an unconsolidated basis, except that the company should consolidate its financial statements with the financial statements of any wholly-owned subsidiaries. 3 These percentage limits on other investments would be calculated only at the time they are acquired. 3 for the company to conduct joint research and development activities with one or more other parties; and (c) are not entered into for the purpose of avoiding regulation under the Act.

5. Other Conditions The company would not be permitted to hold itself out as being engaged in the business of investing, reinvesting or trading in securities. Furthermore, the activities of the company’s officers, directors and employees, its public representations of policies, and its historical development would have to demonstrate that it is primarily engaged in a business or businesses other than investing, reinvesting, owning, holding, or trading in securities. The company’s board would also be required to adopt an appropriate resolution evidencing that the company is primarily engaged in a non-investment business. Anu Dubey Assistant Counsel